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C O N F I D E N T I A L SECTION 01 OF 02 HONG KONG 002263

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STATE FOR EAP/CM AND EEB/IFD/OMA, NSC FOR WILDER AND TONG,  
TREASURY FOR HARSAAGER, YANG, WINTON, CUSHMAN, BEIJING FOR  
LOEVINGER

E.O. 12958: DECL: 08/27/2017

TAGS: [EFIN](#) [ECON](#) [HK](#) [CH](#)

SUBJECT: BANK OF CHINA TAKES CREDIT FOR TIANJIN/HONG KONG  
INVESTMENT SCHEME

REF: HONG KONG 2183

Classified By: Acting EP Chief Craig Reilly, Reason 1.4 (b)

11. (C) Summary: The August 20 announcement by the Chinese State Administration of Foreign Exchange (SAFE) that it would allow Chinese investors to open Hong Kong investment accounts through Bank of China (BOC), Tianjin - Binhai branch helped Hong Kong stocks overcome the fallout from the U.S. subprime mortgage problems and pushed the Hang Seng Index to a record high on August 27. Although the announcement came as a welcome surprise to the market, BOC and SAFE had been discussing this investment scheme for over a year, according to Bank of China International (BOCI) Managing Director for Research Anthony Lok. Lok predicted that Chinese investors would be able to access the Hong Kong Stock Exchange through the BOC, Tianjin - Binhai accounts by mid-September. BOC proposed this reform to SAFE and the People's Bank of China (PBOC) in 2006 and took the lead in developing the innovative mechanism to meet SAFE's concerns about losing control of capital flows. While other Chinese banks are eager to hop on the bandwagon, BOC claims it is the only institution capable of handling the tens of thousands of expected new individual brokerage accounts. BOC expects that it will have a monopoly on Chinese investment in the Hong Kong Stock Exchange for at least the next year. End Summary.

12. (U) From the last week of July through August 17, the Hong Kong Stock Exchange fell over 3000 points (about 13%) as international investors tapped the Hong Kong market for much needed liquidity in the wake of the U.S. subprime mortgage generated credit crunch. Local investors were also selling on concerns about the prospects for the U.S. economy. However, the August 20 SAFE announcement that Chinese investors would soon be allowed to open special accounts to invest in the Hong Kong Stock Exchange reversed what had been up to that point the Hang Seng Index's worst month in several years. By close of trading on August 27, the Hong Kong Stock Exchange not only regained the lost 3000 but pushed to a record high of 23577.73. Despite the enthusiasm for SAFE's announcement, press reports have generated some confusion about who will be allowed to open special investment accounts, how the accounts will operate and when money from Chinese investors could begin entering the Hong Kong Stock Exchange.

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Plans to Allow RMB into HK Market Long-established

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13. (C) Bank of China International Managing Director for

Research, Anthony Lok (protect) explained that although the announcement took the market by surprise, the plan to allow the opening of special accounts had been on the drawing board for some time. BOC had first broached the idea with SAFE more than one year ago and since that time has been developing the mechanisms to allow Renminbi (RMB) deposits to move out of the Chinese market, reducing inflationary pressures in China, while simultaneously meeting SAFE's desire to retain control over RMB outflows. BOCI was surprised by the timing of the SAFE announcement but had expected the scheme would be announced before the end of the year.

14. (C) Lok dismissed speculation that the announcement had been pushed forward to halt the Hong Kong stock market slide.

Instead, the timing of the announcement was driven by SAFE's concern about domestic inflationary pressures before the National People's Congress in early 2008. He noted that there was no limit to the size of the special investment accounts, in contrast to the US\$ 50,000 limit on Qualified Domestic International Investor (QDII) accounts. He attributed the unlimited nature of the BOC accounts both to SAFE's confidence in BOC's ability to create a "closed system" that would prevent RMB from leaving the country and to BOC's own role in developing the model. BOC's proposal was market driven and would not suffer from the same delays and problems that have limited QDII investment thus far, Lok said.

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#### Special Investment Accounts Mechanics

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15. (C) Lok explained that Chinese investors from all over

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China will be able to participate in the BOC managed accounts as long as their local BOC branch has a reciprocal arrangement with BOC, Tianjin - Binhai branch. (Note: the State Council has indicated in the past that the Binhai Special Economic Zone could be developed as a financial innovation center and that the RMB could be traded more freely there. End Note). Currently over 40 branches in major Chinese cities have such a relationship with BOC, Tianjin - Binhai, with more expected to follow. RMB or foreign currency deposits can be used by accountholders to purchase any Hong Kong-listed security. Upon placing their order with BOC, either in person or on-line, BOC will transfer the currency through BOC Tianjin - Binhai to individual investor accounts managed by BOCI in Hong Kong, where it will be exchanged for Hong Kong dollars and invested in the Hong Kong Stock Exchange according to the wishes of the accountholder. The mechanism meets SAFE's requirements that it retain ultimate control of the RMB assets since the accounts will be fully retained within the BOC system. Investors will not have personal access to foreign currency. If they wish to withdraw funds from their special investment accounts, they will need to repatriate the money to their own branches through BOC Tianjin Binhai, where it will be available only as RMB deposits.

16. (C) Although BOC President Li Lihui announced to the press August 26 that Chinese accountholders could begin investing in Hong Kong as early as this week, Lok insisted it would take at least a few more weeks for accounts to become active. Over 10,000 individuals have already signed a waiting list to establish accounts, he said. It will take some time to solicit needed information, transfer funds, and generate accounts for each investor. Lok expects the first Chinese investment accounts will be operational by mid-September. Since Chinese investors would be able to invest in any asset traded on the Hong Kong Stock Exchange, he predicted that trading in warrants would quickly outstrip stock purchases as Chinese investors sought increased returns.

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## BOC Takes Credit, Gets Business

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17. (C) While other Chinese state owned banks have been lobbying to join the special investment account scheme, Lok said only BOCI currently has the capability to support the large numbers of individual investors and the funds to manage such an operation. Analysts at Deutsche Bank speculated that total RMB outflows from the scheme could reach as high as 280 billion over the next 10 months. BOC's position as one of the largest brokerage houses in Hong Kong and its role in developing scheme should give it a monopoly on servicing mainland investors in Hong Kong for at least the next year, according to Lok.

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